No. 2837.

United States

Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

Union Hollywood Water Company, a corporation,
Plaintiff in Error,

vs.

John P. Carter. Collector of the United States Internal Revenue for the Sixth District of the State of California,
Defendant in Error.

BRIEF OF DEFENDANT IN ERROR.

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The plaintiff in this action claims by his complaint a refund of income taxes exacted by the internal revenue collector of the district and paid by the plaintiff on the sum of thirty-three thousand twenty-four dollars and fifty cents for moneys received for making service connections to plaintiff's water plant in the year 1912, and on the sum of fifty-two thousand eight hundred ninety-five dollars and sixty-five cents in that year received

by the plaintiff from property owners by reason of the plaintiff having extended its mains into the property of the payers of said amount.

The Act of August 5, 1909, section 38, provides for a tax on the net income of certain corporations.

> "* * * such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * received within the year from all sources (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties * * *; (second) all losses actually sustained within the year and not compensated by insurance or otherwise * * *; (third) interest actually paid within the year on its bonded or other indebtedness to an amount * * *; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or any state or territory thereof * * *; (fifth) all amounts received by it within the year as dividends upon the stock of other corporations * * *";

The act also provides that on or before the first day of March, 1910, and the first day of March in each year thereafter, a true return, under oath or affirmation, shall be made by each of the corporations, which returns shall show:

> "* * * (first) the total amount of the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year; (second) the total amount of the bonded and other indebtedness of such corporation, joint stock company or asso-

ciation, or insurance company at the close of the year; (third) the gross amount of the income of such corporation, joint stock company or association, or insurance company, received during such year from all sources, and if organized under the laws of a foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia; also the amount received by such corporation, joint stock company or association, or insurance company, within the year by way of dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed by this section; (fourth) the total amount of all the ordinary and necessary expenses actually paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint stock company or association, or insurance company, within the year, stating separately all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property, and if organized under the laws of a foreign country the amount so paid in the maintenance and operation of its business within the United States and its territories, Alaska, and the District of Columbia; (fifth) the total amount of all losses actually sustained during the year and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds;

and in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year in business conducted by it within the United States or its territories, Alaska, and the District of Columbia, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve fund; (sixth) the amount of interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, stating separately all interest paid by it within the year on deposits; or in case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States; (seventh) the amount paid by it within the year for taxes imposed, under the authority of the

United States or any state or territory thereof, and separately the amount so paid by it for taxes imposed by the government of any foreign country as a condition to carrying on business therein; (eighth) the net income of such corporation, joint stock company or association, or insurance company, after making the deductions in this section authorized. All such returns shall as received be transmitted forthwith by the collector to the Commissioner of Internal Revenue."

It would seem quite clear that the corporation in its return is required by law to show the total expense of labor, maintenance, repairs, etc., for each year, and of course those expenses would include whatever labor and materials were necessary for the making of service connections for the year, which amount should certainly be deducted from the entire gross income and a part of the gross income was the receipts for the service connections. and therefore the tax levied and collected upon the first above amount of receipts came within the provision of the statute.

As to the receipts from property owners above mentioned, for extensions into their property, it seems clear that these are a part of the gross income of the corporation for the year. The extensions were permanent improvements and not current expenses incurred in keeping the installed plant in repair, and clearly, under the act referred to, any part of the income of the corporation invested in permanent extensions of the plant are not exempt from the income tax.

Connecticut Mutual Life Insurance Company v. Eaton. 218 Fed. 187 (see page 222).

While the foregoing case does not specifically state that any part of the income of a corporation invested in extensions is not exempt from the tax, yet the discussion on page 222 of the report as to the exemption of an amount expended by the plaintiff in that case for office repairs shows clearly that if that amount had been expended in the acquirement of new properties or extensions the amount would not have been exempt from the tax.

The tax imposed upon corporate franchise by the Tariff Act of 1909 is not an income tax, but is an excess tax upon the privilege of doing business by the corporation, which tax is measured by the income received from all sources by the corporation.

> Flint v. Stone-Tracy Company, 107 U. S. 220;
> Stratton's Independence v. Howbert, 231 U. S. 399.

The bases of rate fixed by the various commissions of the various states, it would seem, is not in any sense the measure of the tax to be paid by corporations subject to the tax under the Act of 1909. It seems that the Supreme Court of the United States fully answered all of the arguments of counsel for the plaintiff in this case, as follows:

> "As to what should be deemed 'income' within the meaning of Sec. 38, it of course need not be such an income as would have been taxable as such, for at that time (the Sixteenth Amendment not having been as yet ratified) income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned. Evidently Congress adopted

the income as the measure of the tax to be imposed with respect to the doing of business in corporate form because it desired that the excise should be imposed, approximately at least, with regard to the amount of benefit presumably derived by such corporations from the current operations of the government. In *Flint v. Stone-Tracy Co.*, 220 U. S. 107, 165, it was held that Congress in exercising the right to tax a legitimate subject of taxation as a franchise or privilege, was not debarred by the Constitution from measuring the taxation by the total income, although derived in part from property which, considered by itself, was not taxable. It was reasonable that Congress should fix upon gross income, *without distinction as to source* (or hours) as a convenient and sufficiently accurate index of the importance of the business transacted. And from this point of view, it makes little difference that the income may arise from a business that theoretically or practically involves a wasting of capital.

"Moreover, Congress evidently intended to adopt a measure of the tax that should be easy of ascertainment and simply and readily applied in practice. The act prescribed that the tax should be 'equivalent to one per centum upon the entire net income over and above $5,000 received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations,' etc., or, with respect to foreign corporations, 'upon the amount of net income over and above $5,000 received by it from business transacted and capital invested within the United States,' etc. And the net income was to be ascertained by taking, first, the 'gross amount

of the income of such corporation * * * received within the year from all sources,' or, in the case of foreign corporations, 'from business transacted and capital invested within,' etc. And the return was to be made under oath by the president and treasurer, or other officer having like duties, indicating in the clearest manner that it was to set forth *data* that with proper accounting would appear upon the books of the corporation. We have no difficulty, therefore, in concluding that the proceeds of ores mined by a corporation from its own premises are to be taken as a part of the gross income of such corporation. Congress no doubt contemplated that such corporations, amongst others, were doing business with a wasting capital, and for such wastage they made due provision in declaring that from the gross income there should be deducted (*inter alia*) 'all losses actually sustained within the year,' including 'a reasonable allowance for depreciation of property, if any,' etc."

Stratton's Independence v. Howbert, 231 U. S. 416-18.

No doubt by reason of the rigidity of the Act of 1909 the Tariff Act of 1913 provided for an allowance in the case of mining corporations as follows:

"And in the case of mines a reasonable allowance for depletion with ores and all other natural deposits and not to exceed five per centum of the gross value at the mine of the output for the year for which the computation is made."

Federal Statutes, Annotated, Supplement of 1914, page 192.

It is respectfully submitted that the complaint in this action shows that the moneys collected by the internal revenue collector, which the plaintiff now seeks to recover, were properly assessed against the income of the corporation.

Respectfully submitted,

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